

**DEPARTMENT OF STATE REVENUE**

**LETTER OF FINDINGS NUMBER: 99-0011**

**Sales and Use Tax**

**For The Period: 1995 - 1997**

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**ISSUES**

**I. Sales and Use Tax: Pattern Shop Patterns**

**Authority:** IC 6-2.5-5-4; Rotation Products Corp. v. Indiana Dept. of State Revenue, 690 N.E.2d 795 (Ind. Tax 1998).

The taxpayer protests the assessment of tax on pattern shop purchases.

**II. Tax Administration: Penalty**

**Authority:** IC 6-8.1-10-2.1; 45 IAC 15-11-2

The taxpayer protests the imposition of a negligence penalty

**STATEMENT OF FACTS**

Taxpayer makes molds/castings that are used to make automotive parts (e.g., brake rotors, brake drums). More facts will be provided as needed below.

**I. Sales and Use Tax: Pattern Shop Patterns and Molds**

**DISCUSSION**

At issue in the protest is the taxpayer's pattern shop. The taxpayer describes its process as follows: patterns are used to make castings/molds. The pattern shop engages in building new patterns and what the taxpayer characterizes as the "remanufacturing" of old patterns. The auditor characterized the work on the old patterns as "repair" work.

Taxpayer states that it takes patterns that have become unusable/obsolete from use in the production process and makes the old patterns the “same as new” by, for instance, “adding stock to make patterns precise and tolerant.” Finally, the taxpayer concludes that the “remanufacture” of patterns “converts items with little or no market value into a marketable product.” Thus, per the taxpayer, equipment used, materials consumed, in “remanufacturing patterns that were broken or otherwise unusable, or remanufactured into repair parts for other manufacturing equipment” should be exempt.

The so-called “industrial/manufacturing exemption” provided in the Indiana Code statutes are cited by the taxpayer:

IC 6-2.5-5-3:

(b) Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for *direct use in the direct production, manufacture, fabrication, assembly . . . processing, refining, or finishing of other tangible personal property.* (Emphasis added)

And the “consumption” exemption, IC 6-2.5-5-5.1:

(b) Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for *direct consumption as a material to be consumed in the direct production of other tangible personal property in the person’s business of manufacturing . . .* (Emphasis added)

Taxpayer, in addition to the above statutes, cites the multi-factor test set forth in Rotation Products Corp. v. Indiana Dept. of State Revenue, 690 N.E.2d 795 (Ind. Tax 1998) as being germane to an analysis of the exemption statutes. Rotation involved a company that was “engaged in the repair and remanufacture of roller bearings” owned by Rotation’s customers. That is, Rotation’s customers (steel and paper mills) brought their unusable roller bearings to Rotation for “remanufacturing.” The Court held that,

Because RPC’s [Rotation] remanufacturing of roller bearings constitutes production within the meaning of the equipment exemption and the consumption exemption, the equipment and materials used in that process are exempt from sales and use tax.

Id. at 805.

The Tax Court arrived at that holding by analyzing four factors: (1) the substantiality and complexity of the work done on the existing article and the physical changes to the existing article; (2) a comparison of the value of the article before and after the work on it; (3) the performance of the article versus that of new articles of the same kind; and (4) whether the work performed on the article is part of the normal life cycle of the existing article. Id. at 803.

Although at first glance the taxpayer’s case seems to fit comfortably within cited statutes and Rotation Products, there is at least one fact that makes it dissimilar. The taxpayer does not sell

the “remanufactured” patterns. The taxpayer does not “remanufacture” the patterns for a third party—that is, unlike Rotation Products, which remanufactured roller bearings for customers—the taxpayer “remanufactured” its patterns for itself. This makes it difficult to see how the taxpayer can come within the ambit of IC 6-2.5-5-3, which is an exemption for “direct use” in the “direct production” of tangible personal property. Assuming, *arguendo*, that the taxpayer is manufacturing, it does not come within the double-direct test envisioned by IC 6-2.5-5-3.

There is, however, a more relevant statute that the taxpayer does not argue (and interestingly, neither did Rotation Products in its case), namely IC 6-2.5-5-4, which states:

Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for his (*sic.*) *direct use in the direct production of the machinery, tools, or equipment* described in section 2 or 3 of this chapter. (Emphasis added)

The patterns are part of the production process, they are not the end result of the production process—they are a piece of equipment. When the patterns become unusable/obsolete, the taxpayer at that point “remanufactures” the patterns, not for resale, but so that they can be used once again in the manufacturing process. Thus the taxpayer is really arguing, it would appear, that the acquisition of property at issue is for the direct use in the manufacturing of machinery, tools, or equipment (i.e., IC 6-2.5-5-4).

The question, even when framed within the correct statute, still remains, Is the taxpayer “remanufacturing” or is it simply repairing the patterns? The four-factor test outlined in Rotation Products is applicable to that question. And as the Tax Court noted in Rotation Products, the analysis of each factor will turn on a “fact sensitive inquiry.” *Id.* at 802.

The taxpayer argues that each of the four-factors is met:

- (1) Substantiality and complexity of the work done on the existing article and the physical changes to the existing article;

The taxpayer’s argument with regard to this factor is the following:

“[S]ubstantial and complex work is done to transform the worn or broken pattern into a new pattern, a useful pattern, and repair part for other equipment. Indeed, the substantiality and complexity is equal to that given to making new patterns from raw materials.”

Taxpayer’s argument on the first factor is almost entirely devoid of *facts*—instead it merely repeats the language of the test. In another letter to the Department by the taxpayer, the following was stated: “[Taxpayer] will build the patterns back up by adding stock to make patterns precise and tolerant . . . .” Unfortunately this adds little to the analysis of whether the taxpayer meets the first factor or not.

The second factor:

(2) A comparison of the value of the article before and after the work on it;

Taxpayer's argument:

“[T]he worn or broken patterns have no market and only have value as scrap, whereas, the new patterns and repair parts have the same value as a new pattern made from raw materials.”

Again, no facts, only an assertion is made. However, the auditor noted to the contrary, stating that a “repaired” pattern “while valuable, was not as good as a new one.”

The third factor:

(3) A comparison of the performance of the remanufactured article with the performance of a newly manufactured article of its kind;

Taxpayer's argument:

“[T]he performance of the repaired and remanufactured patterns and repair parts does not differ significantly from patterns and repair parts manufactured from raw materials.”

“The performance of remanufactured patterns and molds is the same as a new [one] . . .”

No facts are marshaled by the taxpayer to allow one to reach the conclusion that the performance is the same. The auditor reached a different conclusion, actually stating why: “the wood from which the patterns were made was subject to progressive weakening from the heat and pressure of the casting process.” Further the auditor noted that “[u]nreplaced portions of a repaired pattern were not as strong or supple as virgin lumber.”

The final factor:

(4) Is the work performed on the article part of the normal life cycle of the existing article?;

The taxpayer once again merely repeats, in a conclusory fashion, the language of the test (and the parenthetical language of Rotations Products):

“[T]he repair and remanufacture of worn and broken patterns is not a normal part of the patterns life cycle that is tantamount to routine maintenance because there is no expectation that these patterns can be salvaged.”

“[The remanufactured patterns have] a useful life of years.”

In contrast, the auditor stated:

“The repairs were expected as a normal part of the life cycle of a pattern wherein the heat of the casting process weakened and warped the wooden pattern over time.”

Given the “fact sensitive” nature of the four-factor test, and the lack of facts to buttress taxpayer’s arguments, taxpayer has failed to show that pattern shop expenses were exempt.

### **FINDING**

Taxpayer’s protest is denied.

## **II. Tax Administration: Penalty**

### **DISCUSSION**

Indiana Code 6-8.1-10-2.1 states, in part, that if “the deficiency determined by the Department was due to reasonable cause and not willful neglect, the Department shall waive the penalty.” Regulation 45 IAC 15-11-2 also states,

(b) “Negligence” on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer.”

Taxpayer argues that although it has been audited for Indiana sales and use tax “for every year since it was first incorporated,” nonetheless it was not negligent with regards to the collection and self-assessment of tax. To that end, taxpayer notes that taxpayer’s “first two sales and use tax audits dealt primarily with contractor issues and poor control of exemption certificates.” In response to the audits, taxpayer implemented a system to self-assess “use tax on taxable purchases where the vendor had failed to collect sales tax.” Taxpayer, in other words, is arguing that it has taken steps to try and rectify the shortcomings of its self-assessment system.

The implementation of a self-assessment system does evidence reasonable care on the taxpayer’s part.

### **FINDING**

The taxpayer’s protest is sustained.